IN THE TAX COURT – NATAL

CASE NO 11247

In the matter between

A GROUP CC **Appellant**

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE **Respondent**

JUDGMENT

LEVINSOHN J.

We will refer to the parties to this appeal as the "Taxpayer" and the "Commissioner" respectively.

The taxpayer in fact represents a number of entities which by agreement and pursuant to an order of court have been consolidated

into one for the purposes of the tax assessments. This appeal concerns the Commissioner's revised assessments for the tax years 2000, 2001 and 2002 respectively. The taxpayer is represented by the joint liquidators of the various entities. The essential factual background is not in dispute. For the purposes of this appeal the parties have placed before the court a comprehensive set of agreed facts which we will refer to where it is necessary to do so.

During the relevant period one Mrs. B acting through these different entities and represented by agents solicited many millions of Rand from a multitude of investors. Mrs. B held out to these investors that they would receive enormous returns on their money. Initially many received these returns, described as "dividends" and many were tempted to plough back their gains into the scheme. It is common cause that the scheme, apart from being in contravention of the regulations published in terms of the Consumer Affairs (Unfair Business Practices) Act No 71 of 1988, was a fraudulent and unlawful pyramid scheme. It collapsed during March 2002 and substantial losses where incurred. The principal issue in this appeal is whether the amounts paid by the various investors can be said to have been received as gross income within the meaning of Section 1 of the Income Tax Act 58 of 1962 (the Act). The

Appellant no longer contends in these proceedings that they are entitled to claim deductions in terms of S11(a) of the Act.

There is also a dispute in regard to the precise quantum of the assessed amounts. It has been agreed however that it will be unnecessary for us to resolve this in the present proceedings. In the event that the appeal is unsuccessful an appropriate order referring the quantum issue back to the Commissioner would then be made.

Mrs. B used the following *modus operandi* in obtaining funds. Participants would pay their deposit usually through agents. These agents would issue receipts. During the relevant period about 30 000 deposits were made 15 000 of these were under R50 000. It is common cause that the huge inflow of deposits was used to fund the dividends and returns that were promised and to refund an investor's capital where this was required. Mrs. B's micro lending businesses generated insufficient income to make these payments. This led to a situation where Mrs. B had to, as it were, "rob Peter to pay Paul". The demise of the scheme was inevitable. Where a depositor reinvested his/her funds into the scheme a new contract was concluded. A fresh certificate and reference number was issued. Agents would assist in making payments to participants. Funds flowed mostly in cash. Agents

received a commission of 1% per month based on the amount deposited by a participant.

It is estimated that R175 million was paid to agents. The amount retained by the perpetrators of the scheme is unknown but is believed to be substantial. The majority of the participants were losers who ultimately received nothing or less than the amounts that they had invested in the scheme.

The definition set forth in the Act speaks of amounts which have been either “received or accrued”. The concept of accrual connotes an entitlement to the amount. From a taxation point of view it may be that an amount has been “received” before it has actually accrued. Thus while the two concepts may generally speaking overlap, this is not always the case. In the present case we are solely concerned with the concepts of “received” or “receipt” which relates to the physical act of taking possession of the amounts paid by the investors to the various entities. In the course of an ordinary business operation monies that are paid to the business by its customers, for example, ordering goods by mail order, would clearly be regarded as being received within the meaning of the definition of gross income. In the instant case Mrs. B too, operated a business with its own organization and infrastructure.

The funds that she solicited from the investors were physically received and such receipt was acknowledged.

However as we recorded above her activities were unlawful from the start and it is contended by the Taxpayer that this feature places an entirely different complexion on the concept of "receiving" for purposes of the definition of gross income. The argument runs as follows: The contract was an illegal one *ab initio*. Thus, the *condictio ob iniustam causa* was applicable and this meant that from the first moment the money was received the recipient acquired no right to retain it and it thus fell to be refunded. It is therefore contended that in no sense can it be said that there was an actual receipt for the purposes of computing the gross income of the various entities. A necessary and important ingredient of this contention is that the "receiving" was unconditional inasmuch as there is no basis upon which the recipient under this illegal contract would be entitled to retain any of the proceeds. As far as this part of the case is concerned the Commissioner counters by submitting that the payments were not subject to immediate refund. Whether the money fell to be refunded depended on an application of the principles of the *par delictum* rule. To that extent, each of the payments received could not be said to be unconditional.

The oral evidence presented to the court centred principally around the issue of whether the scheme investors knew that this enterprise was an illegal one. We heard the evidence of three witnesses. Two of these were called by the Taxpayer and one by the Commissioner. We do not propose to summarise this evidence. It is sufficient for purposes of this judgment to say that each of these witnesses appeared to be truthful and honest.

As far as the witness Mr. C is concerned the Commissioner's counsel attempted to discredit him by referring to his tax returns. We do not think that this feature in any way detracts from our view that he came across as an honest witness.

The upshot of all this is that no finding can be made one way or the other. Undoubtedly among many thousand investors there would be those who were innocently lured into the scheme. On the other hand there would be these who smelt a rat and who must have suspected that the returns offered were just too good to be true. They would have realized that the scheme was an illegal one. To the extent that the Taxpayer bears the onus of proving that the scheme investors were not in *pari delicto*, in our view this onus has not been discharged.

We proceed now to consider the correctness of the Taxpayer's fundamental premise namely that where money comes into the hands of a person pursuant to an unlawful business activity or as a result of an unlawful contract giving rise to the aforesaid *condictio*, that money cannot be regarded as having been received by such person as gross income within the meaning of the definition. The cornerstone upon which the Taxpayer's submission is based is the case of *Commissioner of Inland Revenue v Genn & Co (Pty) Ltd* 1955(3) SA 293 AD. In *Genn's* case the issue was whether the taxpayer was entitled to deduct from its income certain commissions being in the nature of raising fees in respect of certain loans raised by the taxpayer. The taxpayer used these loans to finance the purchase of stock-in-trade. The question was whether these commissions could be deducted from "Income" i.e. that which remains after s10 exemption had been accounted for, to arrive at "taxable income". Schreiner JA then proceeded to examine whether the commissions in question were expenses incurred in the production of income. The learned judge of appeal concluded that they were.

He then considered a contention which was raised for the first time on appeal. This is based on the provisions of s12(f) & (g) of the 1941 Income Tax Act which were then in force. Section 12 provided that no

deduction shall in any case be made in respect of certain matters, including,

> **"(f) any expenses incurred in respect of any amounts received or accrued which are not included in the term 'income' as defined in this Chapter;**
>
> **(g) any moneys, claimed as a deduction from income derived from trade, which are not wholly or exclusively laid out or expended for the purposes of trade."**

It was argued that amounts borrowed are received by or accrue to the taxpayer within the meaning of s 12(f) which would otherwise have no application at all (see at p 301). The amounts received as loans were in the nature of capital and could not be regarded as forming part of gross income. Accordingly it was contended that any expenditure incurred in connection with loans, even interest payable, was not deductible. The learned judge of appeal rejected the argument and said the following:

> **"I have grave doubts whether this argument does not fail at the outset on the ground that borrowed money is not received nor does it accrue within the meaning either of the**

definition of 'gross income' or of sec. 12(f). It is difficult to see how money obtained on loan can, even for the purposes of the wide definition of 'gross income', be part of the income of the borrower, any more than the value of the tractor which a farmer borrows is to be regarded as being income received otherwise than in cash. Though a borrowing for use differs from a borrowing for consumption in that the borrower in the former case does not become the owner of the thing borrowed and must return it *in specie*, while in the latter case he does become the owner and is only obliged to return what is similar, for present purposes there would seem to be no difference between the two cases. Nor would it seem to make any difference whether or not hire is paid for the use of the tractor or interest for the use of the money. Neither in the case of the borrowed or hired tractor nor in the case of the borrowed or 'hired' money does it seem to accord with ordinary usage to treat what is borrowed or hired as a receipt within the meaning of the definition of 'gross income', or to treat what is paid as rent or interest as paid in respect of something received within the meaning of sec. 12(f).

> **It certainly is not every obtaining of physical control over money or money's worth that constitutes a receipt for the purposes of these provisions. If, for instance, money is obtained and banked by someone as agent or trustee for another, the former has not received it as his income. <u>At the same moment that the borrower is given possession he falls under an obligation to repay</u>. What is borrowed does not become his, except in the sense, irrelevant for present purposes, that if what is borrowed is consumable there is in law a change of ownership in the actual things borrowed."**

In the present case the taxpayer argues that the money received is analogous to the example cited by Schreiner J A in regard to borrowed money which can never be regarded as forming part of the gross income of the borrower. Here it is said that the money is not received because it is tainted with illegality at the very moment it is received. The essential ratio with respect to this part of *Genn's* case appears to be twofold. Firstly, the learned judge of appeal drew an inference from a construction of the legislation that the legislature did not intend to exclude the deduction of interest payable on borrowed money. Secondly, it was incorrect to say that because borrowed money is exempted from forming part of gross income because of its capital

nature, expenditure in connection with loans were not "received" either within the meaning of the definition of gross income or s 12(f).

I venture to suggest with great respect that Schreiner J A in *Genn's* case was essentially concerned with borrowed money. The learned judge emphasised that these borrowings could not be regarded as being received as part of the taxpayer's gross income notwithstanding the wide definition of this concept. Nor would it be correct to regard interest paid as falling within the meaning of s 12(f). The important words at p301 have been highlighted above. "**At the same moment that the borrower is given possession he falls under an obligation to pay**".

It is submitted that the present case is virtually on all fours with the above *dicta* in this sense that because of the underlying illegality, there was no "receipt" within the meaning of the definition of "gross income" and the money fell to be repaid at the very moment it was received.

Counsel have referred us to authorities which hold that the word "receive" in the definition of gross income means a receipt by the taxpayer **on his own behalf and for his own benefit.** In *Geldenhuys v Commissioner for Inland Revenue* 1947(3) SA 256 at p 265 to 266 Steyn J said:

" 'Taxable Income', except in Part V, means the amount remaining after deducting from the income of any person all the amounts (other than abatements) allowed to be deducted or set off under this chapter.

Both 'income' and 'taxable income' are in their respective definitions linked up with the definition of 'gross income' and it seems to be clear that in the definition of 'gross income' the words 'received by or accrued to or in favour of any person' relate to the taxpayer, and the words 'received by' must mean 'received by the taxpayer on his own behalf for his own benefit'."

See also I T C 1545 p 474.

Based on an earlier Appellate Division decision in *CIR v Ochberg* 1931 AD 215 at 228 there may be some difficulty with this formulation of the principle. In a case where the taxpayer contended that he did not derive any benefit from the transfer of the shares into his name and therefore it could not be said that the value of these shares could be regarded as income received, de Villiers JA said the following:

> **"Whether and to what extent the person may have been benefited by the receipt of the income is irrelevant, for that cannot alter the nature of the receipt, converting what is income into capital. The amount of benefit may or may not be a good reason for the Legislature to step in and alter the law, but it cannot affect our decision. As long as the law is what it is, the receipt is income and as such liable to income tax."**

In *Genn's* case supra Schreiner J A referred to *Ochberg's* case at p301G to 302A:

> **"It may be accepted, on the authority of the majority judgments in *Ochberg v Commissioner for Inland Revenue*, 1931 AD 215 at pp 225 – 229, that the presence or absence of a benefit to the taxpayer from something that passes into his possession does not provide a proper test in applying the definition of 'gross income'. But the Court was there dealing with a case where the shares issued to the taxpayer became his own in full ownership, without any accompanying obligation to return them. The transaction was of a type in which benefit was notionally possible, to**

> **the extent at least that what before the transaction did not belong to him became, as a result of it, is property absolutely. The question whether anything is 'received' by a taxpayer, although it is only on loan, was not in issue or considered, and the case is not authority for the view that, in deciding that question, no regard should be paid to the fact that a borrowing, by its very nature, involves a correspondence between what is obtained and the obligation to repay or redeliver."**

Secretary for Inland Revenue v Smant 1973(1) SA 754 AD was a case where a taxpayer had contractually divested himself of his right to receive amounts linked to the par value of shares in a company. The court held that notwithstanding that the company continued paying him these amounts, the taxpayer did not receive the amounts as part of his gross income nor did they accrue to him Holmes JA said at p764:

> **"The position is, therefore, that the latter payments (which are the ones in question in this case) never accrued to the taxpayer, and he was antecedently obliged to transmit them to Plank if he received them from Media, and he did not receive them for his own benefit."**

In my opinion it is necessary to look at the essential nature of the receipt before a determination can be made as to whether it ought to form part of gross income. Deriving a benefit or indeed a potential benefit from the receipt will of course point clearly in that direction. The absence of a benefit could emerge from a contract or from the juridical nature of a particular transaction such as a trust obligation or the right of a usufructuary to lay claim to monies which rightfully belonged to the heirs (see *Geldenhuys' case* supra). I also venture to suggest that in some cases the intention of the recipient may be relevant to the determination. It seems to me also that the absence of benefit must be one which the law as an objective fact recognizes as indeed being absent. In the instant case money was received by Mrs. B pursuant to an illicit enterprise. Her intention was fraudulent and designed to profit from ill-gotten gains. Her scheme, as we have said, was run on business lines with all the necessary infrastructure. Clearly she intended to benefit and by all accounts, did benefit from the money received in the sense that commissions were appropriated therefrom. In my view it would be wrong to say that merely because of the inherently unlawful nature of the transactions and the availability of the *condictio* it could be contended that she derived no benefit and thus the receipts in question should not be regarded as forming part of 'gross income'. This appears to accord with a well recognized and

fundamental principle of taxation law in regard to the receipt of income tainted with illegality which, with respect, is lucidly set forth by Scott J (as he then was), in IT 1545 at p 474 as follows:

> **"Where, however, an amount is received by a taxpayer on his own behalf and for his own benefit but in pursuance of a void transaction there seems to me to be no reason for holding that such amount is not 'received' within the meaning of that section, if that word is to be given its ordinary literal meaning. Not to do so could lead to anomalies. It would mean; for example, that if a trader were to sell his goods on a Sunday in breach of a local by-law, the price paid to him would not be 'received' by him and would not form part of his gross income. I can find nothing in the Act to justify such a construction; nor was any basis suggested by counsel for limiting the meaning of the word 'received' in this way. The mere fact that the receipt was the consequence of a void transaction is no reason for ignoring it. Indeed, it does not follow that because a contract is prohibited by statute and therefore void inter partes, it is to be totally disregarded and all the consequences flowing from it ignored. As pointed out by *Hoexter JA in***

Commissioner for Inland Revenue v Insolvent Estate Botha (supra) **at 556 C-D:**

> **'(I)t is not to be inferred that because an agreement is illegal a court will in all circumstances and for all purposes turn a blind eye to its conclusion; or deny its very existence.'**

The learned judge referred with approval in this regard to *Van der Westhuizen v Engelbrecht and Spouse* and *Engelbrecht v Engelbrecht* 1940 OPD 191 in which Van den Heever J (as he then was) in the course of discussing the consequences of a verbal contract for the sale of land which in terms of the relevant ordinance was 'of no force or effect' observed at 201:

> **"In other directions the contract did have effect. It would have been futile for either party to claim, as against the tax collector, that no sale had taken place or against creditors (supposing that had been the object of the transaction) that no disposition in fraud of creditors had been committed'."**

In an earlier case of *Delogoa Bay Cigarette Co Ltd* 1918 TPD 391 Bristowe J said:

> **"I do not think it is material for the purpose of this case whether the business carried on by the company is legal or illegal. Excess profits duty, like income tax, is leviable on all incomes exceeding the specified minimum, and after making the prescribed calculations and deducting the exemptions, abatements and deductions enumerated in the statute. The source of the income is immaterial."**

In *Commissioner for Inland Revenue v Insolvent Estate Botha (quoted in IT1545 supra)* at p556 Hoexter J A said:

> **"To the conclusion of such illegal agreements the law accords recognition for particular purposes. That they are void inter partes does not rob them of all legal result."**

To sum up therefore, I am of the opinion that notwithstanding the illegal nature of the transactions and the consequences that flow therefrom *inter partes*, there were "receipts" within the meaning of the definition of "gross income" and the Commissioner correctly assessed them as such.

In view of this conclusion I find it unnecessary to consider both the Taxpayer's and the Commissioner's submissions which I have outlined above in regard to the conditionality or otherwise of the payments and the issues that arise from an application of the *par delictum* rule.

In the result the Appeal is dismissed. The assessments are referred back to the Commissioner to consider the quantum of the receipts and if necessary to issue a revised assessment.

Delivered: **2 February 2005**